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Clients&FriendsMemo

Certain Federal Income Tax Provisions of the American Recovery and Reinvestment Act of 2009

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I. Introduction and Summary

Today President Obama signed into law the American Recovery and Reinvestment Act of 2009. This memorandum discusses certain of the federal income tax provisions of the Act that are of most interest to our corporate and financial institutions clients.

- The Act permits certain taxpayers to elect to defer "cancellation of indebtedness" ("COD") income on debt reacquired by the taxpayer or a related person in 2009 and 2010. For calendar year taxpayers, the COD income is deferred until 2014, and then the COD income is included ratably in income each year during the five year period from 2014 through 2018 (i.e., 20% in each year). The provision is available to C corporations, and other taxpayers that issued the reacquired debt in connection with the conduct of a trade or business. Although the Senate version of this provision applied only to repurchases for cash, the enacted version also applies to (i) the exchange of a debt instrument (including an exchange resulting from a modification), (ii) the exchange of a debt instrument for equity, (iii) the contribution of a debt instrument to the capital of the issuer, and (iv) the complete forgiveness of a debt instrument by the holder.
- In Notice 2008-83, the IRS held that deductions claimed by banks with respect to losses on loans or bad debts arising after a section 382 ownership change would not be treated as built-in losses or deductions attributable to periods before the change date.[1] The effect of the Notice was that, with respect to these losses, banks would not be subject to the limitations on losses that would normally apply under section 382 following an ownership change. The Act revokes Notice 2008-83 with respect to section 382 ownership changes occurring after January 16, 2009 (unless the ownership change was pursuant to a written binding contract entered on or before January 16 or a written agreement entered on or before January 16 that was described on or before January 16 in a public announcement or SEC filing).

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[1] Unless otherwise indicated, all references to section numbers are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.

- Very generally, the “applicable high-yield discount obligation” (“AHYDO”) rules defer and/or deny original issue discount (“OID”) deductions to certain issuers of high-yield debt with “significant original issue discount”. The Act suspends the AHYDO rules for debt instruments issued in debt-for-debt exchanges (including exchanges resulting from a significant modification of a debt instrument) after August 31, 2008 and before January 1, 2010. The provision does not apply to exchanges involving outstanding debt instruments that are AHYDOs, certain newly-issued contingent debt, and certain newly-issued debt issued to a person related to the issuer. The provision will help to ensure that debtors that restructure their outstanding non-AHYDO debt are not subject to the AHYDO rules (and therefore are not subject to deferral or loss of OID deductions) on the restructured debt.
- The Act provides that a financial institution that acquires tax-exempt obligations issued during 2009 or 2010 will be denied only 20% (rather than 100%) of the financial institution’s interest expense allocable to the tax-exempt obligations, but only to the extent that the financial institution’s adjusted tax basis of the 2009 and 2010 tax-exempt obligations does not exceed 2% of the financial institution’s adjusted basis of all of its assets. With respect to tax-exempt obligations issued during 2009 and 2010, the Act also expands the definition of a “qualified small issuer” to include any issuer that reasonably anticipates that the amount of tax-exempt obligations that it will issue during the calendar year will be $30 million (rather than only $10 million) or less. Financial institutions generally are denied only 20% of their interest deductions allocable to non-private activity bonds issued by qualified small issuers, regardless of the amount they hold.
- Section 382 generally provides that if a “loss corporation” experiences an “ownership change,” the loss corporation’s ability to use its net operating losses (“NOLs”), certain “built-in losses,” and certain deductions attributable to pre-change periods is subject to an annual limitation equal to the value of the loss corporation immediately before the ownership change multiplied by the long-term tax-exempt interest rate.[2] Without referring to General Motors by name, the Act provides that General Motors will not be subject to section 382's limitations as a result of any ownership change it experiences pursuant to its loan agreement with the Treasury under the Emergency Economic Stabilization Act of 2008, which requires a restructuring to rationalize the costs, capitalization and capacity of General Motor's manufacturing workforce and suppliers. However, under the Act, General Motors will be subject to section 382 limitations if a single

[2] A “loss corporation” is generally defined as a corporation entitled to use a NOL carryover or having a NOL carryover for the taxable year in which the ownership change occurs, or that has a net unrealized built-in loss.

An “ownership change” generally occurs if there is a 50% increase in the shares held by any one or more 5% shareholders during a rolling three years.

Very generally, a “built-in loss” is the amount by which the fair market value of a loss corporation’s asset immediately before a section 382 ownership change is less than the adjusted basis of such asset at that time.

shareholder owns at least 50% of General Motor's stock (by vote or value and taking into account certain attribution rules) immediately after a section 382 ownership change.

- Although both the Senate and the House versions of the Bill contained a provision that would generally extend the carryback period for 2008 and 2009 NOLs from two years to as much as five years, the Act limits this provision to taxpayers with $15 million or less in gross receipts, and only with respect to NOLs arising in a single taxable year beginning or ending in 2008.

The balance of this memorandum describes the first four of these provisions in greater detail.

II. Deferral of COD Income

In general, if a taxpayer's outstanding indebtedness is discharged, or the taxpayer or a person related to the taxpayer repurchases the taxpayer's outstanding indebtedness for an amount that is less than the indebtedness's adjusted issue price,[3] the taxpayer recognizes COD income. COD income may also arise (i) upon an exchange of an issuer's existing debt instrument for a new and significantly different debt instrument or the "significant modification" of an existing debt instrument if, in either case, the issue price of the newly-issued debt instrument (or the deemed-issued debt instrument in the case of a modification) is less than the adjusted issue price of the outstanding debt, (ii) upon the exchange of a debt instrument for equity of the issuer (if the fair market value of the equity is less than the adjusted issue price of the debt instrument), (iii) if a debt instrument is contributed to the capital of the issuer, or (iv) if debt is forgiven.

Debtors in title 11 bankruptcy cases are not required to recognize COD income, and insolvent debtors are not required to recognize COD income to the extent of their insolvency.[4] Instead, these debtors are generally required to reduce certain tax attributes, including NOLs, certain tax credits, capital loss carryovers, and basis in property, by the amount of the COD income.

The Act adds another limited elective exception from current recognition of COD income. Under the Act, a corporation, or any other taxpayer that issued a debt instrument in connection with a trade or business, may irrevocably elect to defer COD income arising from the "acquisition" of the taxpayer's debt instrument in 2009 and 2010 by the taxpayer or any person related to the taxpayer.[5] For this purpose, an "acquisition" includes (i) the acquisition of a debt instrument for cash, (ii) the exchange of a debt instrument for another debt instrument (including any exchange resulting from

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[3] The adjusted issue price of a debt instrument is generally its issue price plus any accrued OID minus any payments other than "qualified stated interest" (which generally is stated interest that is payable at least annually).

[4] Other exceptions exist for certain student loans from indebtedness, real property business indebtedness and qualified principal-residence indebtedness.

[5] A person is related to a taxpayer if they would be related under section 108(e)(4).

the modification of a debt instrument), (iii) the exchange of corporate stock or a partnership instrument for a debt instrument, (iv) the contribution of a debt instrument to the capital of the issuer, and (v) the complete forgiveness of a debt instrument by a holder of the instrument.

COD income that is elected to be deferred under the Act is included in the gross income of the taxpayer ratably in the five taxable years beginning with (i) for reacquisitions in 2009, the fifth taxable year following the taxable year of reacquisition or (ii) for reacquisitions in 2010, the fourth taxable year following the taxable year of reacquisition. Thus, calendar year taxpayers that elect to defer COD income under the provision will defer their COD income realized in 2009 and 2010 until 2014, and will include 20% of the COD income in each of 2014 through 2018.

If a taxpayer elects the benefits of the provision and the taxpayer or a related person issues a newly-issued debt instrument in connection with the acquisition, then any OID on the newly issued debt instrument that accrues before the taxpayer begins to report the deferred COD income also is deferred to the extent of the deferred COD, and is allowed as a deduction ratably over the same five-year period that the COD income accrues.[6]

Any deferred COD income (along with the related deferred deductions for OID) generally is accelerated in the taxable year in which the taxpayer (i) liquidates or sells substantially all of its assets (including in a title 11 or similar case), (ii) ceases to do business, or (iii) experiences similar circumstances.

If the debtor/taxpayer is a partnership, the deferred COD income is allocated to the partners in the partnership immediately before the discharge of indebtedness in the manner it would have been allocated if the COD were recognized, in accordance with the normal partnership accounting rules under section 704. Under the Act, however, any decrease in a partner's share of liabilities as a result of the discharge of indebtedness is not taken into account to the extent the deemed distribution would cause the partner to recognize gain. Instead, the gain arising from the decrease in liabilities is recognized at the same time and, to the extent remaining, in the same amount as COD income is recognized.

A taxpayer that elects to defer COD income under the Act with respect to a debt instrument may not benefit from another of the COD exclusions with respect to the same debt instrument.

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[6] A newly-issued debt instrument may be issued in a debt-for-debt exchange, including a deemed debt-for-debt exchange that arises from a significant modification, or if the taxpayer (or a related person) issues a debt instrument and uses the proceeds to acquire the taxpayer's debt instrument.

If only a portion of the proceeds of a newly-issued debt instrument is used to acquire the outstanding debt, then only the portion of the OID deduction with respect to the newly-issued debt instrument that is equal to the portion of the proceeds of the newly issued debt instrument that was used to acquire the outstanding indebtedness of the taxpayer is deferred.

However, the election is made on a debt-instrument-by-debt-instrument basis. The election is made by including a statement on the taxpayer's tax return for the year of the election.

III. Revocation of Notice 2008-83

In Notice 2008-83, the IRS held that any deduction properly allowed to a bank with respect to losses on loans or bad debts and which arises after a section 382 ownership change would not be treated as a built-in loss or deduction that is attributable to periods before the change date. The rationale for the Notice was that it was difficult to value the loans held by banks and therefore, as a matter of administrative convenience, the bank's loans would be assumed to have a value equal to the bank's basis in them on the change date. The effect of the Notice was to allow banks that experienced section 382 ownership changes to take tax losses for their loans without regard to the annual limitation imposed by section 382. The Notice attracted a good deal of controversy and some members of Congress asserted that it was contrary to the statutory language of section 382.

The Act revokes Notice 2008-83 and generally provides that it no longer has the force of law for section 382 ownership changes occurring after January 16, 2009, unless the section 382 ownership change occurs pursuant to a written binding contract entered into on or before January 16 or a written agreement that was publicly announced on or before January 16, or was required to be filed with the SEC on or before January 16.

IV. Temporary Suspension of AHYDO Rules for Certain Debt Instruments

If a corporate taxpayer issues an AHYDO, OID deductions are denied until the OID is actually paid and a portion of the OID deductions may be permanently denied.

An AHYDO is a debt instrument that (i) is issued by a corporation, (ii) has a term that is more than five years, (iii) has a yield-to-maturity equal to or greater than 5% over the applicable federal rate,[7] and (iv) is issued with "significant original issue discount" which, very generally, means that more than one year of OID may remain unpaid at any time after the first accrual period after the fifth anniversary of the debt instrument's issuance.

In Revenue Procedure 2008-51, the IRS suspended the AHYDO rules for certain permanent loans issued pursuant to a financing commitment. The Revenue Procedure was issued to address the situation where the deterioration of the credit markets caused permanent financings to be treated as AHYDOs even though they generally would not have been had they been issued at the time the initial commitment was entered into.

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[7] The applicable federal rate is a rate that is published monthly and represents the rate the IRS uses to determine interest charges when little or no interest has been charged.

Under the Act, the AHYDO rules are suspended for any debt instrument issued in a debt-for-debt exchange (including a deemed exchange that arises as a result of a significant modification of an outstanding debt instrument) between August 31, 2008 and December 31, 2009. However, the AHYDO rules are not suspended for any newly issued debt instrument that is issued for an existing AHYDO.[8] Moreover, the suspension of the AHYDO rules does not apply for certain newly issued contingent debt instruments or newly-issued debt instruments issued to a person related to the issuer. Although this provision of the Act will supplant the Revenue Procedure in some respects, the Revenue Procedure will still have effect for certain loans that were issued pursuant to commitments (but not debt-for-debt exchanges) and certain other loans issued before August 31, 2008.

Under the Act, the IRS has the authority to extend the suspension of the AHYDO rules beyond 2009 or use a rate that is higher than the applicable federal rate for purposes of applying the AHYDO rules to debt instruments issued after 2009.

V. Extension of De Minimis Safe Harbor Exception for Tax Exempt Interest Expense to Financial Institutions, and Expansion of the Definition of "Small Issuer" for Purposes of the Small Issuer Exception

In general, no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations. However, for a taxpayer that is not a financial institution or a dealer in tax-exempt obligations, interest on indebtedness that is not directly used to purchase tax-exempt obligations is not generally denied if the average adjusted basis of the taxpayer's tax-exempt obligations is 2% or less of the average adjusted basis of all assets held by the taxpayer in the active conduct of its trade or business. Prior to enactment of the Act, this 2% de minimis safe harbor exception was not available to financial institutions,9 but the Act extends the safe harbor exception to financial institutions for tax-exempt obligations issued during 2009 and 2010.[10] Under the Act, an amount of tax-exempt obligations issued during 2009 or 2010 and held by a financial institution to the extent of 2% of the financial institution's adjusted basis in all of its assets is excluded for purposes of determining the financial institution's pro rata interest disallowance.

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8 However, if the newly issued AHYDO is issued for an AHYDO that itself was issued for a non-AHYDO debt instrument, then the AHYDO rules will be suspended.

9 The Act defines a contingent debt instrument by reference to section 871(h)(4). Contingent interest for this purpose generally includes interest determined by reference to (i) receipts, sales, cash flow, income, or profits of the debtor or related person, (ii) changes in value of property of the debtor or related person, or (iii) dividend or partnership distributions of the debtor or related person.

10 For these purposes, a refunding bond (whether a current or advance refunding) is treated as issued on the date of the issuance of the refunded bond (or, in the case of a series of refundings, the original bond).

However, the Act also treats these tax-exempt obligations as “financial institution preference items” with the result that 20% of the interest expense incurred to carry the obligations is denied.

Although, under current law, financial institutions are generally denied a pro rata portion of their interest expense allocable to tax-exempt obligations, the denial does not apply to “qualified tax-exempt obligations.” Instead, only 20% of the interest expense of financial institutions allocable to qualified tax-exempt obligations is denied. A qualified tax-exempt obligation is a tax-exempt obligation that (i) is issued after August 7, 1986, (ii) by a “qualified small issuer” which generally is an issuer that reasonably anticipates that the amount of tax-exempt obligations that it will issue during the calendar year will be $10 million or less, (iii) is not a private activity bond, and (iv) is designated by the issuer as qualifying.

For tax-exempt obligations issued during 2009 and 2010, the Act increases the $10 million annual volume limitation in the definition of “qualified small issuer” to $30 million. In addition, for certain “qualified financing issues,” the Act applies the $30 million annual volume limitation at the borrower level rather than at the level of the pooled financing issuer.[11]

[11] A “qualified financing issue” is, very generally, an issue that is used by a "pooled financing issuer" to finance other "conduit loans" to ultimate "conduit borrowers."

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